Massachusetts Uses Existing Tools to Fight "Exploding" Subprime Mortgages

Fremont case touted as a model for other states

CRL Issue Brief Contacts: Daniel Mosteller, Litigation Counsel at 202-349-1863 February 2009
Uriah King, Policy Associate at 919-313-8519

STATE SHOWS THAT BUSINESS AS USUAL IN SUBPRIME LENDING AMOUNTED TO UNFAIR AND DECEPTIVE PRACTICES.

CRL is encouraged by the recent success of the Massachusetts Attorney General (AG), who used longstanding consumer protection laws to stop foreclosures on unfair subprime loans. CRL believes the AG's approach could serve as an effective litigation strategy for others looking to discourage abusive lending practices, including the ability to require subprime lenders to negotiate with the AG's office before foreclosing.

A Massachusetts court held that originating subprime loans with "teaser" rates was unfair when the homeowner's ability to refinance and avoid foreclosure depends on a rise in property values.

Massachusetts AG Martha Coakley filed suit against subprime lender Fremont Investment & Loan in October 2007, seeking to enjoin it from foreclosing on loans that violated the state's unfair or deceptive acts or practices ("UDAP") law. Patterned on the Federal Trade Commission Act, 15 U.S.C. § 45, the Massachusetts UDAP law, similar to UDAP laws found in most other states, broadly provides that "[u]nfair methods of competition and unfair or deceptive acts or practices in the conduct of any trade or commerce are hereby declared unlawful." Mass. Gen. Law. ch. 93A, § 2.[1] The law also charges the AG with enforcing the law and gives her the power to seek injunctions and recover damages for violations. *Id*. § 4.

The Massachusetts theory

The Massachusetts case centered on the long-term unaffordability of subprime loans created by "exploding" teaser interest rates. This feature ensured that the loans' relatively low start rate would adjust upward significantly, even if market interest rates remained unchanged, once an introductory period (typically two or three years) passed.[2] As a result, subprime borrowers' monthly payments were also destined to increase once the introductory period passed.

But most subprime homeowners could not afford the higher payments because subprime lenders typically qualified borrowers based only on their ability to make the *initial* monthly payment,

[1] CRL recognizes that the UDAP laws in a few states do not cover home lending.
[2] The interest rate after the introductory period, known as the "fully indexed" rate, was contractually set by adding a fixed "margin" to a market interest rate (typically the LIBOR rate) in effect at the time the introductory period ended. The interest rate was destined to increase above the introductory rate because the fixed margin—before adding the market rate of interest—typically approximated or exceeded the introductory rate.

which was tied to the introductory rate—and did not consider whether they had the means to make the payments once that rate expired. Subprime borrowers who could not afford these higher payments either had to refinance into a new loan offering a low interest rate—most likely another exploding teaser rate loan that would allow them to tread water for a couple more years—or face foreclosure. Moreover, refinancing was only possible if the home had appreciated since the last refinancing.

In other words, the subprime loan with the exploding rate was destined for foreclosure unless the cycle of regular refinancing by subprime lenders continued. When the housing bubble popped, refinancing was no longer an option for homeowners trapped in unaffordable loans, and the result was an epidemic of subprime foreclosures that has spread damage throughout the entire economy.

Courts clarify rights and responsibilities in subprime foreclosures

In February 2008, the trial court held that originating subprime teaser rate loans was legally unfair when the ability to refinance and avoid foreclosure depended on property values increasing. This decision was unanimously affirmed by the Massachusetts Supreme Judicial Court in December 2008.[3]

As the Supreme Judicial Court held, "it was unreasonable, and unfair to the borrower, for Fremont to structure its loans on such unsupportable optimism" that "housing prices would improve during the introductory loan term."

The courts specified a combination of four loan characteristics that caused loans to be presumptively unfair under that standard:

1. An adjustable rate mortgage with an introductory rate period of three years or less;

2. The introductory rate was at least three percentage points below the fully indexed rate;

3. The borrower's debt-to-income ratio exceeded 50% if the loan's payment obligation was calculated based on the fully indexed rate; and

4. The loan had a 100% loan-to-value ration or the loan had a substantial prepayment penalty or the prepayment penalty extended beyond the period during which the introductory rate applied.

The courts rejected Fremont's argument that the AG was seeking to impose an impermissibly retroactive concept of unfairness. Instead, they held lenders were on notice from state and federal regulators from as early as the late 1990s of the unfairness of making subprime loans that borrowers were unlikely to repay: "[T]he principle had been clearly stated before 2004 that loans made to borrowers on terms that showed they would be unable to pay and therefore were likely to lead to default, were unsafe and unsound, and probably unfair."[4] Similarly, because the courts

[3] *Commonwealth v. Fremont Investment & Loan*, 897 N.E.2d 548 (Mass. 2008).

[4] The Supreme Judicial Court's opinion well catalogues federal banking regulators' warnings against abusive subprime lending since the late 1990s. The opinion also discusses warnings from Massachusetts banking regulators

found that no federal or state banking regulator had authorized the combination of loan terms identified as presumptively unfair, the courts rejected Fremont's arguments that its lending practices came within the UDAP law's exception for practices otherwise authorized by law.

The trial court accordingly granted a preliminary injunction, upheld by the Supreme Judicial Court, forbidding Fremont from foreclosing on loans secured by an owner-occupied home with these presumptively unfair characteristics without negotiating with the AG's office. If the AG and Fremont could not come to agreement during those negotiations, Fremont had to seek the trial court's permission to commence foreclosure.[5] The courts specified, however, that the ruling does not relieve borrowers from the obligation to repay the loans, and that the AG would have to prove the unfairness of individual loans to permanently stop a foreclosure.

Because the Massachusetts UDAP law is substantially the same as the UDAP laws found in many other states, CRL believes Attorneys General across the nation could adopt a litigation strategy and legal arguments similar to those used by the Massachusetts AG. Using such a strategy could be a very effective way of addressing unfair subprime lending.

- At least three-quarters of subprime loans originated from 2003 and 2007 had an exploding teaser rate feature.

- CRL believes the Massachusetts arguments could be applied to other types of loans, even those without two- or three-year teaser rate, that were destined to be unaffordable over the long-term without refinancing.

- We are also hopeful that courts in other states will find the Massachusetts Supreme Judicial Court's interpretation of the Massachusetts UDAP law as persuasive authority in interpreting their own similarly-worded UDAP laws.

About the Center for Responsible Lending

The Center for Responsible Lending is dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. CRL is a national nonprofit, nonpartisan research and policy organization that promotes responsible lending practices and access to fair terms of credit for low-wealth families.

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and concepts of unfair lending established by Massachusetts' 2004 anti-predatory lending law (which did not cover the loans at issue in this case). The discussion of Massachusetts-specific regulatory guidance and statutes, however, should not limit the persuasive nature of the opinion in interpreting other states' UDAP laws.

[5] Typically, lenders do not have to seek court approval to conduct a foreclosure in Massachusetts.